No. 11,115

IN THE

United States Circuit Court of Appeals

For the Ninth Circuit

American Box Shook Export Association (a corporation),	*Petitioner,*
vs.	
Commissioner of Internal Revenue,	*Respondent.*

BRIEF OF PETITIONER ON REVIEW.

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Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

BRIEF OF PETITIONER ON REVIEW.

JURISDICTION.

Taxpayer's Petition for Review herein involves the determination of a deficiency in income and excess profits taxes for taxpayer's fiscal year ended May 31, 1941 in the respective amounts of $1952.15 income tax deficiency and $1270.32 excess profits tax deficiency. (Record p. 19.) The Petition for Review is taken from the Decision of the Tax Court of the United States entered April 11, 1945. (R. p. 28.)

The case is brought to this Court by a Petition for Review filed July 5, 1945 (R. pp. 105-107, inc.), pursuant to the provisions of Sections 1141 and 1142 of the Internal Revenue Code.

OPINION BELOW.

The only previous opinion in this case is that of the Tax Court of the United States. (R. pp. 21-28, inc.)

STATEMENT OF THE CASE.

The petitioning taxpayer is an association organized under the general corporation laws of the State of California as a successor to an unincorporated association of the same name. The Association consists of 12 members, all of whom are engaged either in the manufacture or in the sale of box shook, or in both such manufacture and sale. The Association was organized under the provisions of the Webb-Pomerene Act to engage only in export trade. It purchased box shook only from its members and exported the box shook so purchased to its customers in foreign countries. All of its purchases of box shook from its members were made upon agreements which provided for the payment by the Association to the member of a minimum price and also provided that such sums as should be received by the taxpayer Association from the resale of the box shook in foreign trade after deducting the cost of doing business, including necessary reserves, should be returned to the members. In other words, the price the member received from the taxpayer Association for its box shook was the final amount received by the Association from its foreign customers less cost of resale. The arrangement between the Association and its members under which the Association acted as the export department of the

various members continued in effect without change from the inception of the organization to the date of the trial in the Tax Court, and the Association did not do any business on any other basis.

In its income tax return for the fiscal year ending May 31, 1941, the year here in question, the taxpayer reported a deduction of some $7599.11, which it had returned to its members during that fiscal year as additional payment for box shook theretofore purchased by it from its members and resold in foreign trade. It retained some thirteen thousand odd dollars as reserve against unforeseen contingencies which might result from the doing of business at long distances during the War. The Treasury Department and the Court below disallowed the deduction of the $7599.11 upon the theory that that payment constituted a dividend by the corporation to its members.

As stated in the Tax Court opinion, the fundamental issue is whether the Petitioner had any taxable income of its own or whether its income was actually at all times the income of its members.

In addition to this fundamental question, the following questions are presented for review:

1. The Tax Court, having found in its "Findings of Fact" that an agreement or understanding was in existence between the taxpayer and its members under which all sums received by the taxpayer Association from the resale of the products of its members, in excess of its business expenses and necessary reserves, were to be returned to the members, its Decision that

this fund was income of the taxpayer Association and not of the members and, therefore, subject to income tax is in violation of the rule that a decision must be supported by Findings of Fact and not be in contravention of the Findings of Fact.

2. The evidence will not support any Finding except that the purchase and sale agreements between the taxpayer Association and its members provided that all sums received by the taxpayer Association from the resale of the box shook purchased by it from its members, after deducting the cost of business, were to be returned to the members and, therefore, the Decision of the Tax Court must be reversed for the reason that it is not supported either by Findings of Fact or by evidence upon which necessary findings could be supported.

SPECIFICATION OF ERRORS RELIED UPON.

1. The Tax Court erred in that its Decision is without support in its Findings of Fact.

2. The Tax Court erred in that its Decision is without support in the evidence.

3. The Tax Court erred in that its Decision that the taxpayer Association was not bound by its purchase and sale agreement with its members is without support in the evidence or in the Findings of Fact.

4. The Tax Court erred in that its conclusions and its Decision are contrary and opposed to its Findings of Fact and to law.

SUMMARY OF THE ARGUMENT.

The questions presented are questions of law under the decision of the Supreme Court in *Dobson v. Commissioner,* 320 U. S. 489, and therefore the subject of review by this Court. (p. 5.)

The Decision of the Tax Court is not founded upon Findings of Fact, but is in opposition to and contrary to the only finding upon the subject. (p. 7.)

The evidence will not support any Finding except a Finding that the taxpayer Association was bound by its purchase and sale agreements with its members and that funds received by it in excess of its expenses were the income of its members and not of the taxpayer Association. (p. 16.)

The question, being one of ownership of property, the status of the property is determined by the law of the State of California. (p. 23.)

ARGUMENT.

THE QUESTIONS FOR REVIEW ARE QUESTIONS OF LAW AND NOT OF FACT.

This case arises on Petition for Review of a Decision of the Tax Court of the United States. In view of the decision of the Supreme Court in *Dobson v. Commissioner,* 320 U. S. 489, it may be well to establish that the questions in issue are questions of "law" and not of "fact" before proceeding with the argument.

As stated by the Tax Court in its opinion:

> "The fundamental issue before us is whether the petitioner had any taxable income of its own or whether its income was actually, at all times, the income of its members. In the event our determination of this issue is adverse to the petitioner a further issue arises, namely, whether the petitioner is entitled to a deduction in the amount of distributions made to its members on May 28, 1941." (R. p. 21.)

Earlier in the preface to its Findings of Fact, the Tax Court stated:

> "The principal issue now in controversy is whether any of the amounts received by the petitioner during the year in question are taxable to it as its income." (R. p. 19.)

The same Court found as a fact:

> "There is an understanding, however, between the petitioner and its members that any amounts received in excess of actual cost, with the exception of amounts placed in a reserve for anticipated claims, is to be returned to them." (R. p. 21.)

We may then state the question thus:

> In view of the contracts between the taxpayer Association and its members, did the sums received by the taxpayer in excess of actual cost belong to it or to its members,

or stated otherwise:

> Was the understanding which was found by the Tax Court as a "fact" a valid and enforceable agreement as a matter of law?

The Supreme Court in the *Dobson* case has, we believe, granted to the decisions of the Tax Court some measure of finality on questions of "fact". Its decision on such questions must have "warrant in the record" by which, we assume, the Court means that there must be evidence to support the findings. If there is, then the findings are apparently unassailable.

No such infallibility attaches to the Tax Court's decision on questions of law, for the Supreme Court says with reference to the Tax Court:

> "In deciding law questions courts may properly attach weight to the decision of points of law by an administrative body having special competence to deal with the subject matter." (Id., p. 502.)

The same may be said for the decisions of any inferior tribunal.

The only question here in issue is whether this taxpayer was bound by valid and enforceable agreements with its members. Surely, there could be no better example of a question of "law" which upon Petition for Review this Court may examine in the light of the evidence submitted.

THE DECISION OF THE TAX COURT IS NOT FOUNDED UPON FINDINGS OF FACT, BUT IS IN OPPOSITION TO AND CONTRARY TO THE ONLY FINDING UPON THE SUBJECT.

The Tax Court having found as a fact:

> "There is an understanding, however, between the petitioner and its members that any amounts

> received in excess of actual cost, with the exception of the amounts placed in a reserve for anticipated claims, is to be returned to them." (R. p. 21.)

its Conclusions of Law as stated in its Opinion to the effect that there was no such understanding are in exact opposition thereto.

In this discussion, it is assumed that the Tax Court is bound by its own Findings of Fact.

The Supreme Court has said:

> "In view of the division of functions between the Tax Court and the reviewing courts it is of course the duty of the Tax Court to distinguish with clarity between what it finds as fact and what conclusion it reaches on the law."
>
> *Dobson v. Commissioner,* 320 U. S. 489, 502.

The Tax Court has done so in the case at bar and has labeled its "Findings of Fact" as such.

It is elementary that the "conclusion it reaches on the law" must find support in the findings of fact for it is from the "facts" that the "conclusions" must be drawn.

In *Rodemeyer v. Meyer,* 30 Cal. App. 514, at 517, the Court states:

> "The court, however, failed to make any finding upon either of these issues; and for this reason the judgment must be reversed. The conclusion of law as found by the court, that plaintiff was not entitled to run water over the three-quarter-acre tract, cannot aid respondent on appeal for the

> reason there is no finding of fact upon which to base such conclusion;"

In *Schoolcraft v. B. O. Kendall Co.*, 108 Cal. App. 546, at 549, the Court states:

> "It is a rule of law that conclusions of law are binding to the extent only that they are supported by findings of fact."

Here the Tax Court found an understanding between the taxpayer and its members that *"any* amounts received in excess of actual cost, with the exception of amounts placed in a reserve for anticipated claims, is to be *returned* to them". (R. p. 21.) Clearly if the excess money were to be "returned" to the members, it was originally the members' money, held by the taxpayer not as its own but in a fiduciary capacity. One "returns" what one has borrowed. One does not "return" to a member money the member never owned.

"Return" is defined in Webster's Dictionary as:

> "Return. To bring, carry, put or send back, as to return a borrowed book or a hired horse; to repay, to give back."

The word "understanding" is that used by the laymen witnesses at the trial, who referred to the agreements of purchase and sale between the members and taxpayer Association at various times as "understanding" (R. pp. 57-107); as the "arrangement" (R. p. 101); as an "agreement" (R. p. 103); and as a "plan of operation". (R. p. 62.)

"Understanding" is defined in Webster's Dictionary as follows:

> "Understanding.—An agreement of opinion or feeling; an adjustment of differences; anything mutually understood or agreed upon; as. to come to an understanding with another. A mutual agreement not formally entered into but having definite engagements; as, an understanding between two nations."

and by Bouvier:

> "Understanding. It may denote an informal agreement or a concurrence as to its terms. *Barkow v. Sanger,* 47 Wis. 500, 3 N. W. 16. A valid contract engagement of a somewhat informal character. *Winslow v. Dakota Lumber Co.,* 32 Minn. 237, 20 N. W. 145."

"Arrangement" is defined by Webster as:

> "An agreement or settlement of details made in anticipation; as, arrangements for receiving company; settlement; adjustment by agreement; as, the parties made an arrangement of their disputes."

"Agreement" is defined as:

> "a concurrence in an engagement that something shall be done or omitted; an exchange of promises; mutual understanding, arrangement or stipulation."

Of these words so variously used, the Tax Court has chosen to refer only to use of the word "understanding".

In its Opinion the Court nowhere denies the existence of the agreements that the money of the members was to be returned to them: Its Decision is apparently based upon a conclusion that the agreement "was not carried out in practice". (R. p. 23.)

If this statement in the "Opinion" is a "conclusion on the law", it is based upon no "finding of fact" and is contrary to the only finding on the subject.

If the statement is looked upon as a "finding of fact" then it violates the Supreme Court's instruction to distinguish with clarity between the matters of fact and of opinion. But a more forceful objection may be made. A finding of fact must be based upon evidence. The only evidence on the point is:

> "A. We found we had received additional realization, a total of which represented—rather, the total of which that we felt might be distributed safely without hazard—or without depleting our reserve for additional cost would represent 50 cents a thousand board feet." (R. p. 62.)

In simpler words and with figures added for clarity:

> We had received $20,000 more than we had paid our members and decided that we could pay out $7000.00 of that sum without hazard and without depleting necessary reserves.

The Tax Court then recites that of the $20,967.77, which the taxpayer Association had on hand, after the payment of its expenses, at the end of the fiscal year (May 31, 1941), it returned $7559.11 to its members.

As to the balance of that money, that is $13,317.66, the Court states:

> "What disposition was to be made of this amount, we do not know. There is *nothing* in the record to show that it could not be used for the payment of dividends on the stock, or for any other purpose. Other than the amounts actually distributed to the members, of which we shall speak later, there is nothing to show that the petitioner's earnings were not its own which it could use for any ordinary corporate purpose." (R. p. 23.)

We may first point that this remark is diametrically opposed to the Tax Court's own Finding of Fact to the effect that *all* amounts received in excess of actual cost and necessary reserves were to be returned to the members. We may also remark that all of the evidence is to the effect that the money was to be returned to the members and that there is no evidence that the corporation could use it for any other purpose. In view of the Finding of Fact, it is difficult to say that the Tax Court overlooked or ignored the evidence, but nevertheless the statement is without support in the evidence; there is not only no evidence to support it, but it is diametrically opposed to all of the evidence on the subject.

After making the above quoted statement, the Tax Court discusses the case of *San Joaquin Valley Producers Assn. v. Commissioner,* 132 Fed. (2d) 382, a case decided by this Court, and then states with reference to the case at bar:

> "Here, however, as we have noted, neither the statute under which it was incorporated, its articles of incorporation, its by-laws *nor any other contract forbade the petitioner from having income of its own.* Under such circumstances, it can not be said that the petitioner's income was actually that of its members." (Italics ours.) (R. p. 25.)

The whole point at issue in the case from the inception thereof has been whether or not the taxpayer Association was bound by its purchase and sale contracts with its members; or, stated otherwise, whether those contracts were valid and enforceable. The agreements all provide that the sums received by the Petitioner in excess of cost of doing business were to be returned to the members. The Tax Court has recognized the existence of the agreements in its Finding of Fact and has nowhere found that the contracts were not valid and enforceable. The evidence shows that the affairs of the corporation were conducted in accordance with the provisions of those agreements from its inception to the date of the trial. We do not assume, in its reference to any *other* contract, that the Tax Court was referring to something not in the record as the only contracts pleaded and the only contracts in existence were the purchase and sale contracts between the Association and its members. The fact that they were of an informal character and that the entire business of the Association was so conducted makes them, nonetheless, valid and binding.

One other point deserves attention, and that is the stress laid by the Tax Court (p. 27 of the Record) upon a phrase which it has quoted from the testimony of the witness Hudson. The quotation is as follows:

> "Attention was further called to the fact that the Association had been set up as a non-profit organization with the understanding that any excess received from the sale of shook over expenses would, *upon action of the organization,* be subject to distribution as additional realization on shipments made during the period when such surplus was accumulated." (The italics are that of the Tax Court.)

In order that there could be no doubt as to the meaning of that phrase, Counsel for the respondent inquired of the witness Hudson as to its meaning and was answered in the following language:

> "I ask you, assuming you know, whether action was taken by this taxpayer organization in connection with all distributions made by the corporation?
>
> "A. Yes. I would say that the word 'action' may or may not be as definite as you have in mind.
>
> The Directors discussed the realization over a given period. Naturally there was a feeling there should be held back a cushion, or you might say a small revolving fund to take care of contingencies, and so it was just a matter of judgment as to whether we could safely distribute 50 cents or 75 cents or $1 a thousand additional in view of the returns to date, and that phrase there, 'upon action of the organization', referred to that policy, that it would be a matter of judgment to be de-

> termined by the directors as to *how much of the additional realization might safely at that moment be paid against shipments.*" (Rep. pp. 81-82.) (Italics ours.)

Later and in answer to a further question, witness Hudson stated:

> "I am sure that was understood to mean that the directors should approve of any additional realization, merely because it was a matter of judgment as to whether there were still some delayed liabilities which might dissipate some of that additional realization later." (R. p. 82.)

It will, of course, be admitted that the funds received from the sales by taxpayer Association in the export trade of the products it had theretofore received from its members would result in funds coming into the treasury of the taxpayer Association, and it would also seem to be clear that some action would have to be taken by the taxpayer Association in order that those funds could be transferred to the members to whom they belonged. It would also seem to be clear that there might be differences in judgment as to the amount of reserves that should be temporarily withheld pending settlement of claims or other expenses which might, and often do, result in shipment of goods during wartime.

In the case at bar, the directors obviously felt, as the evidence shows, that they should withhold some $13,000.00 odd dollars to cover any possible contingency in the shipments that had been made in the pre-

vious fiscal year and that sum was in addition to the $4000.00 already held in reserve. The balance of some $7000.00 odd dollars they felt could safely be distributed.

In so acting they were carrying out to the letter the agreements under which the Petitioner had purchased the box shook from its members.

We, therefore, respectfully submit that the Decision of the Tax Court must be reversed in view of the fact that its Conclusions and Decision are not supported by its Findings of Fact, but are opposed to its only Finding of Fact upon the question in issue.

THE EVIDENCE WILL NOT SUPPORT ANY FINDING EXCEPT A FINDING THAT THE TAXPAYER MADE VALID AND ENFORCEABLE AGREEMENTS WITH EACH AND ALL OF ITS MEMBERS; THAT ALL SUMS RECEIVED BY IT IN THE COURSE OF ITS BUSINESS, AND NOT NECESSARY FOR ITS ACTUAL EXPENSES OF DOING BUSINESS AND NECESSARY RESERVES, WERE TO BE RETURNED TO ITS MEMBERS, AND ANY OTHER FINDING OR CONCLUSION IS WITHOUT SUPPORT IN THE EVIDENCE.

The Tax Court has found that the Petitioner was organized in 1940 to succeed an unincorporated corporation of the same name, which, in turn, was organized in 1935. As to that fact the witness Hudson testified as follows:

> "My proposal to members of this industry when we set up the organization in 1935 was that this would be a service organization, actually just an export department of their own firms. There

> would be no profits accrue. It would be operated merely on the basis of meeting its own expenses so far as possible during the first thirty months of the organization." (R. p. 48.)

At page 51 of the Record, witness Hudson read the following statement, which was quoted from the Minutes of a Meeting held July 29, 1940:

> "Attention was further called to the fact that the Association had been set up as a non-profit organization, with the understanding that any excess received from the sale of shook over expenses would, upon action of the organization, be subject to distribution as additional realization on shipments made during the period when such surplus was accumulated."

The witness was thereafter asked:

> "Q. Mr. Hudson, do either of the statements you have read reflect the understanding you have just testified to?
>
> A. The second statement (the last one quoted above) reflects the understanding we have had and do have at the present time with our members." (R. p. 57.)
>
> "Q. Under the date of July 29, 1940, or previous thereto, or when?
>
> A. It accurately reflects the understanding I have had from the very beginning of this project, whether unincorporated or incorporated." (R. p. 57.)

With respect to the distribution of the $7559.11 to the members in 1941 and which was claimed by the

taxpayers as a deduction on its income tax return, the witness Hudson testified as follows:

> "We found we had received additional realization, a total of which represented—rather the total of which that we felt might be distributed safely without hazard—or without depleting our reserve for additional cost would represent 50 cents a thousand board feet." (R. p. 62.)

Thereafter the witness was asked:

> "Q. Now, Mr. Hudson, was the same plan of operation to which you have testified the same arrangement with your members carried on throughout the fiscal year June 1, 1940, to May 31, 1941?
>
> A. Yes.
>
> Q. And have you continued to operate under that plan since?
>
> A. We have." (R. pp. 62-63.)

Upon cross-examination of the witness Hudson, Counsel for the respondent quoted from a questionnaire, attached to the income tax return, the following statement:

> "It is intended that a preliminary price be settled monthly with the understanding that any excess received from the sale of shook over expenses would, upon action of the organization, be subject to distribution as additional realization on shipments made during the period when such excess was accumulated.
>
> Q. I ask you, assuming you know, whether action was taken by this taxpayer organization in connection with all distributions made by the corporation?

A. Yes. I would say that the word 'action' may or may not be as definite as you have in mind.

The directors discussed the realization over a given period. Naturally there was a feeling there should be held back a cushion, or you might say a small revolving fund to take care of contingencies, and so it was just a matter of judgment as to whether we could safely distribute 50 cents or 75 cents or $1 a thousand additional in view of the returns to date, and that phrase there, 'upon action of the organization', referred to that policy, that it would be a matter of judgment to be determined by the directors as to how much of the additional realization might safely at that moment be paid against shipments.

Q. Well, then, it was necessary, and that necessity was recognized in connection with every distribution, that the directors act in accordance with it, is that right?

A. That the directors more or less approve the distribution.

Q. Well, they had to approve it before it was made, of course?

A. That's right.

Q. And that was necessary to their plan?

A. Well, the phrase occurs in there, 'upon action of the organization'. It occurs in the minutes, I believe of July, that we read, and in that statement carried on the questionnaire, that phrase occurs, and I am sure that was understood to mean that the directors should approve of any additional realization, merely because it was a matter of judgment as to whether there were still some delayed liabilities which might dissipate some of that additional realization later." (R. pp. 81-83, inc.)

Such is the testimony of the principal witness, the General Manager of the taxpayer Association, and there is no evidence of any kind in the Record which in any manner opposes or disputes the accuracy of the testimony of that witness.

Two other witnesses were called. Both of those witnesses were directors of the taxpayer Association and each of them was an official of a member corporation.

The first of those witnesses was Mr. J. F. O'Brien, the General Manager of the California Pine Box Distributors, a cooperative selling organization. His testimony is as follows:

> "Q. Now, Mr. O'Brien, this arrangement that you have testified to, under which your California Pine Box Distributors Association sold lumber to American Box Shook Export Association, did that preliminary billing price arrangement continue throughout this fiscal year of June 1, 1940, to May 31, 1941?
>
> A. Yes, sir.
>
> Q. Has it continued since?
>
> A. Yes, sir.
>
> Q. Has there been any change?
>
> A. We have never made a sale except with the understanding that it is preliminary, that any additional realization is ours.
>
> Mr. Wallace. That is all.
>
> Mr. Murray. No questions.
>
> The Court. You are excused."
>
> (Witness excused.) (R. p. 101.)

Mr. J. W. Rodgers, President of the Western Box Distributors and Vice President of the Lassen Lumber & Box Company, testified as follows:

"Q. Did you have any agreements or understanding with the American Box Shook Export Association as to the terms of those sales?
A. Mr. Hudson would indicate a price that he could afford to pay us. Sometimes it was agreeable to us, and sometimes it wasn't. He would tell us that there was a ceiling price, and any additional realization we would naturally participate in, that amount being uncertain, all depending on what his overhead was and his claims, and everything connected with the Export Association.
Q. Did that arrangement continue throughout this fiscal year?
A. Well, it was our understanding from the outset that that was the arrangement.
Q. Has there been any variation in that arrangement from the time you became a member to this moment?
A. Only in the matter of realization we got.
Q. You mean only in the matter of the amount?
A. The matter of the amount of realization that we got. The amounts varied from year to year, depending on the volume handled." (R. pp. 103-4.)

To say in the face of this evidence, and there is no other evidence, that "there is nothing to show that the petitioner's earnings were not its own which it could use for any ordinary corporate purpose" is to make a statement diametrically opposite to all of the evidence and without any support in the evidence. It was the position of the taxpayer before the Bureau of Internal Revenue, before the Tax Court, and is the taxpayer's position here that it was bound by valid and enforceable agreements with its members.

Let us assume that instead of as a tax case, the case at bar arose upon the claim of one of the members for its proportionate share of money held by the taxpayer, in excess of its actual expenses and necessary reserves, and not distributed. Then let us summarize the evidence. The General Manager of the taxpayer has testified that he originally organized the Association to be nothing more or less than an export department for the various corporations and associations which were members thereof. He explained that at that time each of the members was assessed an amount sufficient to cover the expenses of the Association. By 1940 this manner of operation had become too cumbersome. In view of the then difficulties of world trade, a corporation was organized under the provisions of the Webb-Pomerene Act to engage only in the export trade. The General Manager of the new corporation explained to all of the members that the association would operate upon a plan under which it purchased box shook only from its members and only for export. It would pay its members a minimum price, would then attempt to sell the product so purchased from its members to foreign buyers and would add sufficiently to the price to cover its expenses and a little more. If after paying its expenses, paying claims and other similar charges any funds were left over, they were to be returned to the members. Once each year the members were to meet, look over the financial accounts and determine what amount of the excess could safely then be returned to the members. The General Manager and the members testified that that arrangement had been car-

ried out from the inception of the corporation to the date of the trial. We believe no Court would state upon that evidence that the excess earnings belonged to the Association and not to its members, or would state that "there is nothing to show that petitioner's earnings were not its own, which it could use for any ordinary corporate purpose".

LEGAL PRINCIPLES INVOLVED.

Since the decision of this Court in the case of *San Joaquin Poultry Producers Association v. Commissioner,* 136 Fed. (2d) 382, the rule that non-profit business associations, conducted for the benefit of members thereof, were not taxable and that the sums held by such corporations or associations in reserve, or otherwise, belonged, not to the association, but to the members thereof, has been settled.

The fact that the Poultry Producers Association was organized under the provisions of the Agricultural Code of the State of California and that its By-Laws contained provisions clearly indicating the fiduciary capacity of the Association led to further litigation between the Commissioner and actual non-profit associations which were not so organized. One of these cases was that of *United Cooperatives, Inc., v. Commissioner,* which was decided by the Tax Court on September 29, 1944, and is reported in Volume 4 of Tax Court Decisions. In that case, the cooperative was organized under the general corporation act of In-

diana and the by-laws provided for the setting up of reserves and also provided that the directors might declare dividends of not in excess of 8% of the par value of the stock. During the year in question the Directors declared no dividends, but the net income of the corporation was refunded to its members ratably in what were referred to as "patronage dividends". The Tax Court properly held that the form of the corporation was of no consequence; that the so-called "patronage dividends" were simply the return of funds to the members of the association to which they were entitled and that whether they were called "patronage dividends" or "rebates", made no difference.

The crucial question in this case, as it was originally stated by the Commissioner of Internal Revenue, was whether or not there was a binding obligation upon the taxpayer to return the excess funds to its members. (R. p. 11.) If there was such an agreement, then the excess income belonged to the members and not to the association. The question of whether or not there was a binding agreement was a question of law and not of fact. All of the witnesses testified there was such an agreement, and there is no evidence to the contrary.

In the closing paragraph of its Opinion, the Tax Court states:

> "The taxpayer points to no statute authorizing the claimed deductions. Clearly they are not deductible expenses. The petitioner was under no obligation to make distribution to its members until the board of directors had so acted. Whether

the payments were in the nature of dividends we need not decide. But see *Fontana Power Co.,* 43 B.T.A. 1090, affirmed 127 Fed. (2d) 193; *Juneau Dairies, Inc.,* 44 B.T.A. 759. We are of the opinion that the petitioner is not entitled to the deduction in any event and that the respondent's determination must be sustained."

The answer is simple: Whose money was it? If it belonged to the members then the members, not the association, should pay the taxes. If it belonged to the members, it was their 'income', not that of the Association.

That the Board of Directors made up only of the representatives of members reserved to itself the right to insure that all possible bills were paid before distribution of the surplus fund does not mean that the Association could withhold payment of its members' money any more than a stockbroker could keep for himself the funds he received from the sale of his clients' stock. He has a right to deduct his proper charges and the balance he must remit.

The *Fontana Power* case (127 Fed. (2d) 193) and the *Juneau Dairies* case, 44 B.T.A. 759, are neither of them in point.

In the *Fontana* case, the point in issue was whether certain payments were deductible as "interest" or were in fact "dividends". This Court held the payments were not interest on an "indebtedness", and, therefore, not deductible. No such question arises here. Our question is: "Was the money held by the Association

due to its members as payment for box shook purchased by the association from its members?".

The *Juneau Dairies* case was decided by the Board of Tax Appeals nearly two years before the decision of this Court in the *San Joaquin Valley Poultry Producers* case and turns upon the fact that the Dairies corporation dealt both with members and non-members, but distributed its "profits" only to members.

The points raised by the Tax Court in the final paragraph of its Opinion have been the subject of substantial litigation in the State of California. The original payment of a minimum price for the member's goods, the withholding of reserves and the necessity for "action by the organization" before distribution have all been litigated. A good example of such litigation is the case of *Mountain View Walnut Growers Assn. v. California Walnut Growers Assn.*, 19 Cal. App. (2d) 227, decided in February of 1937. The question in that case was as to the actual ownership of funds withheld as reserves, in an identical manner and under identical circumstances to the case at Bar. The Walnut Growers Association had purchased the walnuts from its members and had resold them under an agreement in which they were first to deduct their expenses, plus a reasonable sum for reserves, and pay the balance over to the members. The Court held, and properly so, that the reserve fund was a trust fund and had always been treated as such; that the fund was held for the benefit of the members and that they should receive it after it had served its purpose because at all times it

was their property under their agreement with the selling association.

Since *U. S. v. Robbins,* 269 U. S. 315, there has been no doubt but that the local law on questions of ownership of property governs in the Federal Court. This doctrine was reaffirmed in *Poe v. Seaborn,* 282 U. S. 101, where at page 110, Mr. Justice Roberts, delivering the opinion of the Court, states:

> "The Commissioner concedes that the answer to the question involved in the case must be found in the provisions of the law of the state, as to a wife's ownership of or interest in the community property. What, then, is the law of Washington as to ownership of community property and of community income including the earnings of the husband's and wife's labor?
>
> The answer is found in the statutes of the state, and the decisions interpreting them."

We respectfully submit that under the laws of the State of California and the decisions interpreting those laws there can be no question but that the taxpayer Association, a California corporation, is bound by the terms of its contracts of purchase and sale and the funds, in excess of its costs, resulting from the resale by the taxpayer Association of the products theretofore purchased by it from its members must be returned to those members.

The sums in question in this case were the property not of the Petitioner but of its members and the Petitioner Association was not therefore subject to the payment of income tax thereon.

We respectfully submit that the Decision of the Tax Court of the United States should be reversed.

Dated, San Francisco,
October 29, 1945.

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